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Fed Shift from "Put" to "Collar" Bodes Well for Spread Product

When the Greenspan-led Federal Reserve aggressively intervened to halt the 1987 stock market slide via the press, money markets, rate cuts, and moral suasion, **the Fed "put" was born**. The pattern of Fed action to stem market weakness and prevent economic contagion also emerged with the rate cuts in response to the collapse of Long-Term Capital Management and the Russian-default crisis in 1998. **The most recent example of the Fed "put" arrived in December 2018 when the Fed shifted from "more hikes warranted" to the current, so-called symmetric bias** (i.e., relax, we're back on our heels). It was a shift seemingly brought about by weakness in the equity and credit markets as much as anything else.

While the "put" is well recognized at this point, **an equal and opposite phenomenon—a soft "Fed cap" on risk products—has arguably emerged over the last several years as well**. Economists both inside and outside of the Fed have made the case that promptly ending quantitative easing (QE) and raising rates was necessary to prevent economic overheating and the emergence of an inflation problem. Those same parties also repeated the "desirability of being pre-emptive" mantra throughout the policy-normalization process.

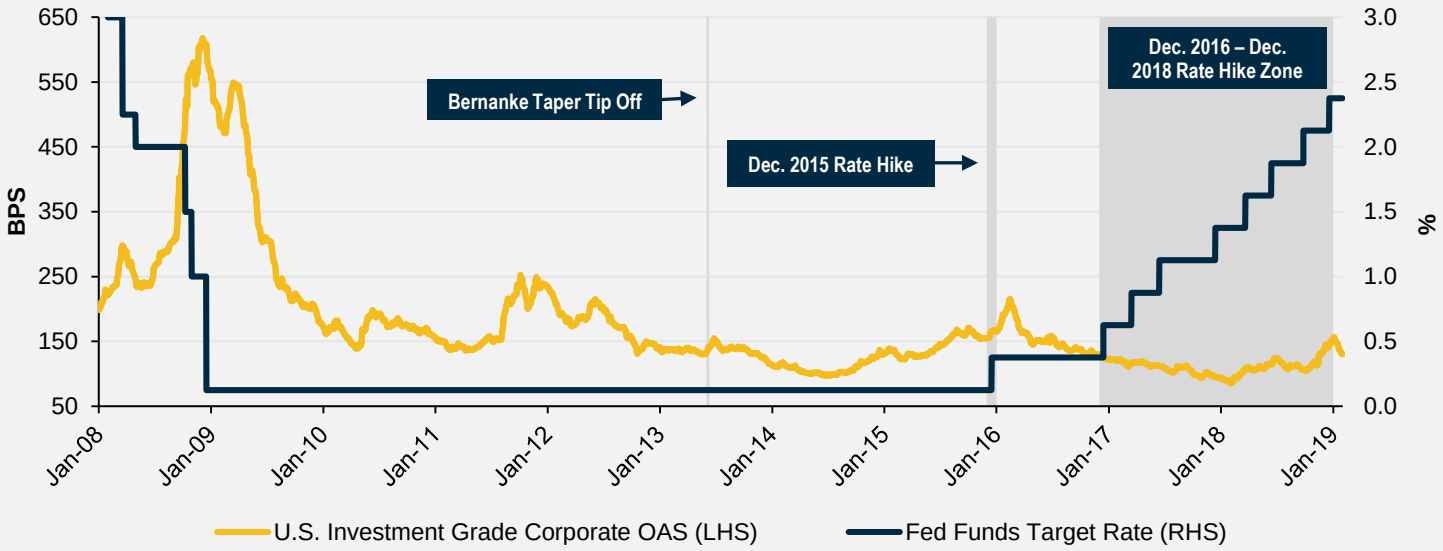
After a half century of rising debt levels around the developed world, central bankers have become all-too aware of the risks presented by asset bubbles and excessive credit extension. As a result, central bankers have also become more pre-emptive in tightening policy, seemingly in an effort to prevent excessive market enthusiasm and careless lending against dangerously high asset valuations.

The concern of the Yellen-led Federal Reserve regarding market excesses became evident when it started the most recent rate-hiking cycle with inflation still well short of the 2% target. In fact, core PCE was closer to 1% and heading lower. The first hike, and those that followed, occurred during periods of market buoyancy. In contrast, when the markets recoiled, as in September 2015 and at the end of 2018, the Fed paused. **Hence, the Fed "collar" was born. Indeed, the Fed appears to have implicitly adopted a "market-collar" approach, becoming more accommodative when markets become too risk averse (the so called "Fed put")**, **but also removing accommodation if markets become too ebullient (the "Fed cap").**[1]

[1] *In options trading, a collar position is created by buying an out-of-the-money put option while simultaneously writing an out-of-the-money call option on an existing long equity position. The put protects the trader in case the price of the stock drops while selling the call caps potential gains.*

FIGURE 1: U.S. INVESTMENT GRADE CORPORATE SPREADS VS. THE FEDERAL FUNDS TARGET RATE

In retrospect, the advent of the Fed collar has been clear over the last several years. The periods of tightening adjustments—announcing the taper, the first hike in 2015, and the series of rate hikes from December 2016 through 2018—occurred against a backdrop of low to moderate spread levels and what were referred to as "elevated" stock market levels. In other words, the Fed removed accommodation not only to head off inflation, but to prevent market excesses—that's the cap. By contrast, periods of market turbulence have all seen the Fed quickly turn to caution—that's the put. This was the case with the decision to hold the Fed funds rate steady in September 2015, the dovish rhetoric and extended pause over much of 2016, and the recent policy reorientation from hikes to caution following the December 2018 meeting.



Source: Bloomberg Barclays as of January 31, 2019

The Fed's recent moves have demonstrated a fine degree of control over the markets. Indeed, the rate hikes and balance sheet roll off in 2018 capped market optimism, underscoring the Fed's relevancy as a restraining influence. But just as important, the Fed's recent about face has demonstrated its leverage to support markets—and the economy via the markets—if need be. In contrast to many other central banks around the world that are currently looking at their policy options with their backs against zero or negative interest-rate floors, the Fed appears to be in a good spot. **To the benefit of the economy, it has established a collar on the markets—it can resume hikes to prevent excessive froth should it reemerge as a risk, or it can increase accommodation and ease financial conditions to provide support.**

CONCLUSION

The end of an expansion cycle for equities and credit has historically emerged from unchecked growth followed by excessive policy tightening by tone-deaf central bankers. The collar effect puts this Fed on a middle path, intent on avoiding either an over-optimistic, bubble-prone environment, but also keen on stemming market weakness that could cause a damaging downside scenario. The result may well be a prolonged economic expansion with perhaps a volatile, but extended, cycle for spread-product outperformance versus government securities.

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Source(s) of data (unless otherwise noted): PGIM Fixed Income as of February 2019.

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